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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 487

WILLIAM MALAT AND ETHEL MALAT, PETITIONERS

v.

ROBERT A. RIDDELL, DISTRICT DIRECTOR OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The district court's memorandum opinion, findings of fact, and conclusions of law (R. 8–25) are not officially reported. The opinion of the court of appeals (R. 28–35) is reported at 347 F. 2d 23.

JURISDICTION

The judgment of the court of appeals was entered on May 27, 1965 (R. 35). The petition for a writ of certiorari was filed on August 23, 1965, and was granted on November 8, 1965 (R. 36; 382 U.S. 900). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether a taxpayer who holds property for either rental or sale to customers is entitled to capital gain treatment on the sale of such property in the normal course of business.

2. Whether there is adequate support in the record for the finding of the district court, which was affirmed by the court of appeals, that the property here in question was held for either rental or sale to customers in the ordinary course of business.

STATUTE INVOLVED

Internal Revenue Code of 1954:

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

* * * * *

(26 U.S.C. 1221.)

STATEMENT

During the tax year here in question, 1956, and for a number of earlier years petitioner[1] was engaged

[1] Mrs. Malat is a party solely because she and her husband filed a joint income tax return for the year 1956. We refer to Mr. Malat as "petitioner."

full time in the real estate business, principally as a general partner in Louis Lesser Enterprises, Ltd. In the five years between its formation (R. 78) and the year here in issue, Lesser Enterprises had participated in a large number of real estate ventures, including the construction and rental of over 300 duplex apartment buildings and homes (R. 39, 74–77), the ownership and rental of an office building (R. 73), the organization of at least two shopping center projects (R. 39, 74–75), a number of ventures which subdivided large tracts of land, installed roads and utilities, and sold lots in the ordinary course of business (R. 40, 69–71, 72, 74, 22–23), and at least five separate sales of unimproved, bulk land for a gross sales price of more than $967,000.[2] On June 30, 1956

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[2] There was testimony concerning the following five sales of raw land:

	Sales price
Buena Park—100 acres (Ex. A, p. 6; R. 121–122)	$621,116.
Century Crenshaw Plaza Sale to Ponty—10.9 acres (Ex. A, p. 6; R. 4, 23–24)	222,800.
Century Crenshaw Plaza Sale to Hicks-Fenmore Development Co.—9 acres (Ex. A, p. 6; R. 4, 24)	123,781.
Lesser, Himmelstein, Bochet parcel (R. 73)	Price not stated.
Garden Canyon Development—40 to 60 acres (R. 73–74, 75–76, 78, 122–123)	Price not stated.
Total	967,697.

Lesser Enterprises' tax return indicates that it was also involved in at least three additional sales of land for a total price of $355,435. There was no testimony concerning two sales for

Lesser Enterprises had approximately $1,200,000 invested in land, joint ventures and partnerships (Ex. A, p. 4); during its 1956 tax year it received $171,000 in real estate commissions (Ex. A, p. 2; R. 77), had a net profit of approximately $275,000 from partnerships and ventures in the real estate business (Ex. A, p. 3; R. 69–77, 22–23), and reported a net profit of over $230,000 on sales of land (Ex. A, p. 6).

Petitioner was also a general partner in Lesser Industrial Properties which purchased land and constructed warehouses, factories, and similar industrial facilities for rental (R. 39). In addition to petitioner's real estate activities as a general partner in Lesser Enterprises and Lesser Industrial, he personally held interests in some real estate subdivisions and a shopping center (R. 40).

In 1954 petitioner, acting on behalf of Lesser Enterprises, formed a joint venture called Century Crenshaw Plaza, with the idea of acquiring a 45-acre parcel of land fronting on Century and Crenshaw Boulevards in Inglewood, California (R. 43, 64, 21). The joint venture was composed of five members, each with a 20 percent interest. In addition to Lesser Enterprises (which was represented by petitioner), the other venturers were Hicks, a real estate

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$248,000 and $64,670, respectively (Ex. A, pp. 5, 6). Petitioner testified that the third sale (for $42,765) was made to a partnership in which Lesser Enterprises had a continuing interest (R. 122; Ex. A, p. 6).

Exhibit A (unprinted) is the tax return for Louis Lesser Enterprises for the year ended June 30, 1956, which is contained in a supplemental record certified to this Court.

broker (R. 46, 108); Fenmore, a lawyer who was engaged primarily in the real estate business and was a licensed real estate broker (R. 112, 94, 96, 100–101, 108; Ex. 5, para. 14 (unprinted)); Millman, who had previously been in the dress business but was then actively looking for real estate deals (R. 46, 96, 100–101); and Rogen, who was involved in at least one other real estate venture with some of the same parties (R. 42, 63, 100–101).

On February 15, 1954 the joint venture acquired the 45 acre tract for $486,000 (R. 21–22).[3] There is some dispute about the purpose for which the venturers acquired the property. Petitioner testified that the property was in a "fast-growing area" and the venturers hoped to obtain sufficient financing at favorable terms to construct "a major apartment project" on it (R. 42, 118). However, he also testified that the mortgage market had been "rough", and they realized there was a substantial possibility that they might be unable to get "financing that would permit us to * * * get what we felt was a reasonable return on our equity investment," in which case they would sell the land if that was more profitable (R. 83–84, 118, 116, 100). One of the other venturers, Mr. Fenmore, testified that they "bought it [the land] * * * [because] there was a chance to make a very substantial profit on the sale or sales" (R. 100).

[3] The property had previously been in escrow for 6 months during which the seller and the venturers had it rezoned from agricultural to multiple residential dwellings. At the same time an adjacent piece of property which the seller retained was rezoned commercial. R. 21–22.

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The venturers first explored the possibility of obtaining financing to construct a large number of buildings containing approximately 1000 apartments (R. 46–49). However, the mortgage market continued to be "rough" and they were unable to get financing at terms that would have permitted them the profit they expected (R. 83–84, 118). The venturers then subdivided the inside 25 acres of the tract into 105 lots, put in streets and curbs, and installed water and sewage facilities (R. 22–23). All of these lots were sold at a profit within 9 months after the venturers had acquired the property (R. 9).[4] The venture reported the gains from the sales of these 105 lots as ordinary income on its information return and each of the venturers (including Lesser Enterprises and, through it, petitioner) reported these gains as ordinary income on their tax returns (R. 9, 23).[5] Meanwhile, the venturers explored, without success, the possibility of rezoning the two parcels fronting

[4] After the joint venture subdivided the inner portion into 105 lots and put in streets and utilities, it distributed that 25 acre portion of the tract to the five venturers who then formed a second joint venture, Century Crenshaw Properties, to which they transferred the subdivided 25 acres. Both joint ventures were owned by the same parties in the same proportions, except that Fenmore and Hicks each owned their interests in the second venture through corporations which they controlled. Thus the actual sales of the 105 lots were accomplished through the second joint venture (R. 22–23).

[5] A joint venture is taxed the same as a partnership. 1954 Code § 7701(a)(2). Both are required to file information returns, and the partners or joint venturers are taxed individually

on Century and Crenshaw Boulevards (totalling 20 acres) for commercial development (R. 51–52).

On October 15, and November 5, 1954 (eight and nine months, respectively, after acquisition of the tract) the joint venture sold the two frontage parcels. The nine acre piece fronting on Century Boulevard was sold for $123,781 to Hicks-Fenmore Development Co., which was a partnership comprised of Hicks, Fenmore and two corporations controlled by them. It eventually built a gasoline station on part of the property. The 11 acre parcel fronting on Crenshaw Boulevard was sold for $222,800 to George Ponty, a real estate developer, who built a number of apartment buildings on the property. (R. 23–24, 109, 93–94.)[6] While all parties concerned treated the subdivided 25 acre tract as having been held primarily for sale to customers in the ordinary course of busi-

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on their respective shares of the partnership's or joint venture's income. 1954 Code §§ 701, 702.

[6] There was some conflicting testimony as to whether a dispute among the venturers contributed to the decision to sell the two frontage parcels. Petitioner testified that "a lack of rapport amongst the partners" was one of the reasons for the two sales (R. 118). Another of the venturers, Mr. Fenmore, testified that there was no serious disagreement between the venturers until after the sales here in question (R. 99–101). In any event, the district court concluded on the basis of all the evidence that "[t]he rift between the partners may have expedited the sale but it appears that the failure to obtain rezoning and satisfactory financing was the primary cause of the sale which was the step intended by the parties to be taken at the time the property was acquired and while it was held, if the rezoning and financing failed" (R. 17, see also R. 25).

ness and reported the profits on sales of the 105 lots as ordinary income (R. 4, 23), the joint venture reported its approximately $127,000 gain from the sale of the remaining 20 acres as long-term capital gain on its information return.[7] The venturers, including Lesser Enterprises and, through it, petitioner, reported their shares of the profit as long-term capital gain (R. 4, 24). The Commissioner determined that the gain from the two sales should have been reported as ordinary income and asserted a deficiency against petitioner. He paid the deficiency and commenced the instant suit for a refund (R. 2–3).

The district court concluded that the "property was purchased and held for development *or sale* depending on which course appeared to be most profitable" (R. 17, emphasis in orginal; see also R. 22, 24–25, 125) and that the "[p]laintiffs have failed to establish by a preponderance of the evidence that the subject real properties were not held by Plaza primarily for sale to customers in the ordinary course of a trade or business" (R. 24). The district court accordingly held that petitioner "should have reported such gains as ordinary income" (R. 25).

The court of appeals affirmed, stating that "the record amply supports" the district court's finding that the property was acquired and held for sale or

[7] The joint venture originally paid $486,000 for the 45 acres. It allocated $266,765 to the subdivided 25 acres and $219,235 to the 20 acres of frontage land. The latter were sold for a total of $346,582, yielding a gain of $127,347. The subdivided land was also sold at a gain, but the record does not indicate the amount. R. 4, 23–24.

rental, whichever was more profitable (R. 34). The court noted that "in the case of one who deals generally in real estate the rational inference is that the purpose of the holding is all-encompassing," *i.e.*, that "the property was acquired and held with the purpose of realizing gain from it in any feasible manner which might present itself"; a real estate "dealer is, after all, in the business of acting in precisely that fashion" (R. 33, 34).

INTRODUCTION AND SUMMARY OF ARGUMENT

If a taxpayer is in the business of selling real estate, it is clear that his regular, recurring gains from sales of real estate will be taxed as ordinary income. Similarly, if the taxpayer is in the business of purchasing or constructing buildings which he rents out, his rental income constitutes ordinary income. (The same thing would, of course, be true if the taxpayer was in the business of either purchasing or manufacturing personal property which he then sold or which he then leased.) This case presents the question whether a taxpayer who is in the business of acquiring real estate (or personal property) which he holds for the dual purpose of either rental or sale, whichever is more profitable, can properly report his profits from sales in the normal course of business as capital gain.

The Internal Revenue Code defines capital gain as the profit resulting from the "sale or exchange" of "property" other than, *inter alia*, "property held by the taxpayer primarily for sale to customers in the

ordinary course of his trade or business." 1954 Code §§ 1221, 1222. Petitioner and other taxpayers who have acquired or manufactured assets for the dual purpose of either sale or rental in the regular course of their businesses have argued that they are entitled to capital gain because assets held for such a dual purpose are not held *"primarily"* for sale in the ordinary course of business. At best, they argue, their sale and rental motives were equal and thus neither was *primary;* in those cases where the taxpayers derive a majority of their revenue from rentals and only a minority from sales, they contend that the "primary" purpose for holding the asset was for rental rather than sale.

We shall show in Point I that "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss," *Corn Products Co.* v. *Commissioner,* 350 U.S. 46, 52, and meant only those gains that were "separate from the main-stream of the enterprise" to receive preferential capital gains treatment. *Recordak Corp.* v. *United States,* 325 F. 2d 460, 462 (Ct. Cl.). Manifestly, a taxpayer who is in the regular business of manufacturing or acquiring assets which he will either rent or sell depending on whichever outlet proves most advantageous should not be able to treat his normal business profits from sales as capital gains.

In a long line of decisions dealing with the capital gain provision this Court has held that the "exclusions [from capital gain treatment must be] inter-

preted broadly" when necessary "to effectuate the basic congressional purpose," *Corn Products Co.* v. *Commissioner,* 350 U.S. at 52, and that where necessary to prevent tax avoidance the language of the capital gain statute will be read in other than its "ordinary sense." *Commissioner* v. *Gillette Motor Co.,* 364 U.S. 130, 134. Moreover, the Court has in other contexts held that, where it is "more consonant with the legislative purpose" of a statute, the word "primarily" can be read as meaning "essentially" or "substantial." *Board of Governors* v. *Agnew,* 329 U.S. 441, 446, 447. Therefore, we believe, as do the majority of the courts which have ruled on the question, that a taxpayer in the business of manufacturing or purchasing property for either rental or sale in the normal course of business—so that sale in the ordinary course of business is one of his "essential" or "substantial" purposes for holding the asset—must pay an ordinary income tax on his gains from such regular business sales.

In Point II we shall show that the district court necessarily found, first, that the joint venture held the property here in question for the purpose of exploiting it in any manner which proved most profitable, including rental or sale in the ordinary course of business, and, thus, that an essential or substantial purpose for holding the property was for sale to customers in the ordinary course of business. Petitioner spends the major portion of his brief attempting to reargue the district court's factual findings, which were affirmed by the court of appeals. This

Court will not ordinarily review the concurrent findings of two lower courts. However, in any event, these essentially factual findings are, as the court of appeals held, "amply support[ed]" by the record.

ARGUMENT

I

A TAXPAYER WHO PURCHASES AN ASSET FOR EITHER RENTAL OR SALE IN THE ORDINARY COURSE OF HIS BUSINESS, WHICHEVER IS MORE PROFITABLE, IS NOT ENTITLED TO HAVE HIS REGULAR BUSINESS PROFITS FROM ITS SALE TAXED AS CAPITAL GAINS

In general, the Internal Revenue Code imposes an ordinary income tax on the profits derived from carrying on a trade or business.[8] This is true regardless of whether the regular business income is in the form of compensation for services, rental income, or proceeds from the sale of property. However, the Code generally gives preferential tax treatment to gains derived from sales of property outside the scope of normal business operations, on the theory that they usually result from a long-term passive investment.

If a taxpayer regularly purchases an item for resale, it is clear that his business profits derived from sales

[8] It is sometimes difficult to determine whether the particular activities from which the taxpayer derives his profit constitute a part of his trade or business, or are merely incidental profit-making activities. If the former, profits are taxable as ordinary income; if the latter, as capital gain. As we point out below (see *infra*, p. 29), if the taxpayer's "business" is defined unduly narrowly or technically—for example, if a realtor's business were viewed as the selling of a particular type of property rather than the real estate business generally—the inevitable effect would be to allow capital gains treatment on profits that actually are generated by the taxpayer's business activities.

of such items will be taxed as ordinary income. On the other hand, if the taxpayer were not in the business of selling such an item, his profit on the transaction would generally be taxed as capital gain. For example, a taxpayer who purchases a painting or a parcel of real estate and sells it at a profit after the requisite holding period is generally taxed at capital gain rates. If, however, the taxpayer in question was in the business of dealing in such property, his gain would be taxed as ordinary income. "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss," and that only those transactions "which are not the normal source of business income" would be taxed as capital gain. *Corn Products Co.* v. *Commissioner,* 350 U.S. at 52.[9]

However, in recent years there have been an increasing number of cases involving taxpayers in the dual business of either renting or selling a product, depending on the demand at the moment. These taxpayers have contended that although their profits on sales of such products are a normal and regular source of income, they must nevertheless be taxed at the preferential capital gain rate because the product was not "held * * * *primarily* for sale to customers in the ordinary course of his trade or business." 1954 Code

[9] The courts have enunciated a number of factors which bear on the question whether a taxpayer is engaged in a particular business, but in essence the application of this broad standard to a particular set of facts has been left to the trier of fact, subject to the "clearly erroneous" test. See *infra*, p. 23.

§ 1221 (1) [emphasis added].[10] According to this argument, "primarily" has reference to the taxpayer's chief or principal motive in holding the property in question, and if more than half of the taxpayer's revenues are from rental, his "chief" motive for holding the product is the production of rental income.

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[10] Congress first enacted a preferential rate for capital gains in 1921 in order to give "profits earned over a series of years" some relief from the graduated tax rates on ordinary income. H. Rep. No. 350, 67th Cong., 1st Sess., pp. 10–11 (1939–1 Cum. Bull. (Part 2) at 176); S. Rep. No. 275, 67th Cong., 1st Sess., pp. 12–13 (1939–1 Cum. Bull. (Part 2) at 189–190). The original statute excluded from capital gain treatment "stock in trade" and "inventory." Revenue Act of 1921, c. 136, 42 Stat. 227, § 206(a)(6). In 1924 in order "to remove any doubt as to whether property [such as real estate] which is held primarily for resale constitutes a capital asset, whether or not it is the type of property which under good accounting practice would be included in the inventory" (H. Rep. No. 179, 68th Cong., 1st Sess., p. 19 (1939–1 Cum. Bull. (Part 2) at 255); S. Rep. No. 398, 68th Cong., 1st Sess., p. 22 (1939–1 Cum. Bull. (Part 2) at 281), Congress added an exception for "property held by the taxpayer primarily for sale in the course of his trade or business." Revenue Act of 1924, c. 234, 43 Stat. 253, § 208 (a)(8). During the depression a number of taxpayers who traded actively in the stock market on their own accounts were deducting stock market losses against ordinary income. Congress felt that such deductions should be subjected to the limitations on capital losses. Therefore, in order to make "it impossible to contend that a stock speculator trading on his own account" is in the trade or business of selling stocks (H. Conf. Rep. No. 1385, 73d Cong., 2d Sess., p. 22 (Amendment No. 66) (1939–1 Cum. Bull. (Part 2) at 632), Congress in 1934 amended the statutory exception to read "property held by the taxpayer primarily for sale *to customers* in the *ordinary* course of his trade or business." Revenue Act of 1934, c. 277, 48 Stat. 680, § 117(b) (words in italics added in 1934). See also authorities cited *infra*, p. 31, fn. 25.

The same principles are, of course, applicable whether the case involves real estate or personal property. A taxpayer regularly in the business of holding land either for rental or for sale may acquire a particular parcel with the intention of exploiting it by whichever means proves most profitable. If he normally derives the majority of his income from rentals or if he testifies that his preponderant motive was to rent rather than resell the parcel in question, he may claim that his profit from an immediate resale in the ordinary course of business constitutes capital gain. See, *e.g.*, *Rollingwood Corp.* v. *Commissioner*, 190 F. 2d 263 (C.A. 9) (taxpayer built 700 houses on a tract of land and offered them for rent with an option to purchase; within four years it had sold all of the houses); *Meridian, Inc.* v. *Commissioner*, 322 F. 2d 198 (C.A. 6), certiorari denied, 375 U.S. 992 (taxpayer constructed eight large commercial and industrial buildings according to the specifications of its tenants; most of them were leased with an option to purchase, and at least five of the options were exercised).

In all of these cases the taxpayers derived their regular business profits from two sources—rentals and sales. Regardless of which source gave rise to more revenue, it is clear that neither type of income should be capital gain. "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 [now 1954 Code § 1221] applies to

transactions in property which are not the normal source of business income." *Corn Products Co.* v. *Commissioner,* 350 U.S. 46, 52.

This Court has made it clear that a taxpayer cannot channel ordinary business profits into capital gain. If "necessary to effectuate the basic congressional purpose," "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly." In no event may "the capital-asset provision * * * be so broadly applied as to defeat rather than further the purpose of Congress." *Corn Products Co.* v. *Commissioner,* 350 U.S. at 52. The Court has frequently read the words of the capital gain statute in other than their "ordinary sense" when necessary to carry out "the purpose of Congress" in enacting the capital gain section. *Commissioner* v. *Gillette Motor Co.,* 364 U.S. 130, 134. Whenever possible the Court has read the statutory exceptions to capital gain broadly, so as to exclude "profits * * * arising from the everyday operation of a business"; even when this was not possible the Court has denied capital gain to such profits by narrowly reading the definition of a capital asset. See *Corn Products Co.* v. *Commissioner,* 350 U.S. 46; *Commissioner* v. *Gillette Motor Co.,* 364 U.S. 130; *Commissioner* v. *P. G. Lake, Inc.,* 356 U.S. 260; *Burnet* v. *Harmel,* 287 U.S. 103; *Hort* v. *Commissioner,* 313 U.S. 28; *Kieselbach* v. *Commissioner,* 317 U.S. 399; *Watson* v. *Commissioner,* 345 U.S. 544; *United States* v. *Midland-Ross Corporation,* 381 U.S. 54.

There are, accordingly, two ways in which the Court could reach the result here advocated by the Commis-

sioner—either by narrowly reading the definition of a capital asset [11] or by broadly reading the exception for property held "primarily" for sale to customers in the ordinary course of business. Since the above statutory exception can easily be read to cover assets held for rental or sale in the normal course of business, we believe that the Court need not adopt the former alternative in this case.

Petitioner argues that the word "primarily" must be read as meaning "of first importance" or "chief." However, this Court has held that when necessary to implement the clear legislative purpose of a statute, the word "primarily" can be read as meaning "essentially" or "fundamentally" and that an "activity or function may be 'primary' in that sense if it is substantial." In *Board of Governors* v. *Agnew*, 329 U.S. 441, this Court examined a provision of the Banking Act of 1933 which prohibited any member of a partnership "primarily engaged" in the underwriting business from serving as an officer, director or employee of a federal bank. The respondents were directors of a federal bank and also partners of a brokerage firm deriving approximately 30 percent of its revenues from underwriting. The court of appeals had held that in order for a firm to be "primarily

[11] See, *e.g.*, *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, where the Court held that corn futures—which are concededly capital assets in the hands of some taxpayers—are not capital assets when held by a taxpayer which used them as "an integral part of its business" (p. 50). Similarly, we submit that assets held for sale-or-rental as an integral part of a taxpayer's normal business operations cannot be classified as capital assets.

engaged" in underwriting, that must be its chief or principal business. This Court reversed, saying (p. 446):

> It is true that "primary" when applied to a single subject often means first, chief, or principal. But that is not always the case. For other accepted and common meanings of "primarily" are "essentially" (Oxford English Dictionary) or "fundamentally" (Webster's New International). An activity or function may be "primary" in that sense if it is substantial. If the underwriting business of a firm is substantial, the firm is engaged in the underwriting business in a primary way, though by any quantitative test underwriting may not be its chief or principal activity. On the facts in this record we would find it hard to say that underwriting was not one primary activity of the firm and brokerage another. * * *

Such a construction of the word primarily is, concluded the Court, "not only permissible but also more consonant with the legislative purpose than the construction which the Court of Appeals adopted." In light of the "evil at which the section was aimed," "the line between substantial and unsubstantial seems to us to be the one indicated by the words 'primarily engaged.'" *Id.* at 447.

Similarly, in the instant case, it would clearly be "more consonant with the legislative purpose" to interpret "primarily" as including any case where one of the *essential* or *substantial* reasons for holding the asset was for sale to customers in the ordinary course

of business.[12] "[T]he evil at which * * * [§ 1221(1)] was aimed" is clear. It was designed to differentiate between "the profits and losses arising from the everyday operation of a business" (*Corn Products Co.* v. *Commissioner*, 350 U.S. at 52), on the one hand, and gains and losses resulting from a passive "appreciation in value accrued over a substantial period of time," on the other. *Commissioner* v. *Gillette Motor Co.*, 364 U.S. at 134; see H. Rep. No. 350, 67th Cong., 1st Sess., pp. 10–11 (1939–1 Cum. Bull. (Part 2) at 176; S. Rep. No. 275, 67th Cong., 1st Sess., pp. 12–13 (1939–1 Cum. Bull. (Part 2) at 189–190). In this context "the line between substantial and unsubstantial seems to us to be the one indicated by the [statutory] words" (*Board of Governors* v. *Agnew*, 329 U.S. at 447) "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." 1954 Code § 1221(1). Congress certainly did not intend to convert a taxpayer's regular business profits into capital gains merely because he both rented and sold the same type of asset.

Such reasoning has led three courts of appeals and the Court of Claims (as well as the Tax Court) to agree with the Commissioner's position. *Rollingwood*

[12] See also, *e.g.*, *Griffiths* v. *Commissioner*, 308 U.S. 355, 358 ("Legislative words * * * derive vitality from the obvious purposes at which they are aimed * * * ."); *United States* v. *American Trucking Ass'ns*, 310 U.S. 534, 542 ("The function of the courts * * * is to construe the language so as to give effect to the intent of Congress."); *Farmers Irrigation Co.* v. *McComb*, 337 U.S. 755, 764 ("We have * * * consistently refused to pervert the process of interpretation by mechanically applying definitions in unintended contexts.").

Corp. v. *Commissioner,* 190 F. 2d 263 (C.A. 9); *Greene-Haldeman* v. *Commissioner,* 282 F. 2d 884 (C.A. 9); *American Can Co.* v. *Commissioner,* 317 F. 2d 604 (C.A. 2), certiorari denied, 375 U.S. 993; *S.E.C. Corp.* v. *United States,* 140 F. Supp. 717 (S.D.N.Y.), affirmed *per curiam,* 241 F. 2d 416 (C.A. 2), certiorari denied, 354 U.S. 909; *Meridian, Inc.* v. *Commissioner,* 322 F. 2d 198 (C.A. 6), certiorari denied, 375 U.S. 992; *Recordak Corp.* v. *United States,* 325 F. 2d 460 (Ct. Cl.); *Bauschard* v. *Commissioner,* 279 F. 2d 115 (C.A. 6); *Harrah* v. *Commissioner,* 30 T.C. 1236.[13] The Eighth and Fifth Circuits have reached a contrary conclusion. *Municipal Bond Corp.* v. *Commissioner,* 341 F. 2d 683 (C.A. 8), and *United States* v. *Bennett,* 186 F. 2d 407 (C.A. 5).[14]

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[13] See also American Law Institute, *Definitional Problems in Capital Gains Taxation,* Discussion Draft, pp. 323–326 (Oct. 20, 1960), concluding that the gain should be ordinary income in such circumstances.

[14] The *Bennett* case dealt with the issue in a rather unusual context, *i.e.*, in light of the conditions present in the cattle industry. Because of the special problems presented by breeding animals, Congress subsequently enacted a special statutory provision exempting all breeding animals from the test here in question. Compare 1954 Code § 1231(b)(3) with § 1231(b)(1)(B). See Treas. Reg. § 1.1231–2 (b), (c) Example 3.

The Eighth Circuit in *Municipal Bond* relied heavily on *Bennett,* on its own earlier decision in *Albright* v. *United States,* 173 F. 2d 339 (C.A. 8), and on the Sixth Circuit's decision in *Gotfredson* v. *United States,* 303 F. 2d 464. All of these cases dealt with the sale of breeding animals; in fact, *Gotfredson* turned on the special statutory provision enacted to exempt breeding animals from the test here in question. In other cases, not dealing with breeding animals, the Sixth Circuit has, both before and after its *Gotfredson* decision, consistently agreed with the position here advocated by the Commissioner. *Meridian, Inc.* v. *Commissioner, supra; Bauschard* v. *Commissioner, supra.*

The *Recordak* case involved a taxpayer which manufactured microfilming equipment for either rental or sale. The Court of Claims commented that if sales are a part of the "normal stream" of the taxpayer's "[b]usiness enterprise," they are to be taxed at ordinary rates; only "gains classed as separate from the main-stream of the enterprise will receive more lenient treatment." In no event will "sales which form an accepted part of the taxpayer's regular business" be taxed at capital gain rates. "Whatever the precise scope of [the word 'primarily'] * * * in other contexts, it does not exclude from ordinary income the proceeds of sales by one, like plaintiff, who conducts a dual enterprise involving both rentals and sales of the same type of goods. In that setting, 'primarily' invokes a contrast, not between selling and renting, but between selling in the ordinary course of business and selling outside of that normal course. Accordingly, if the entrepreneur holds out his wares either for sale or for rental, the taxation of his business gain from sales does not depend upon a comparison of sales to rentals in the particular year." *Recordak Corp.* v. *United States,* 325 F. 2d 460, 462, 463 (Ct. Cl.).

Similarly, the *S.E.C. Corp.* case involved a taxpayer which held food and beverage coolers for either sale or rental and disposed of them "through whichever outlet materialized first or proved most advantageous." In denying capital gain treatment the court stated that "To carve out of its business for special tax treatment gains actually realized as a normal feature of the taxpayer's current business would" cause the

capital gain provision to "become a source of windfalls" to a taxpayer in "a rent-or-sell business," "rather than a relief from hardship." *S.E.C. Corp.* v. *United States,* 140 F. Supp. 717, 719, 720 (S.D. N.Y.), affirmed *per curiam,* 241 F. 2d 416 (C.A. 2), certiorari denied, 354 U.S. 909.

Therefore, we believe that the gain from a sale of real estate made in the ordinary course of business is taxable as ordinary income, although such sale was only one of the substantial purposes for which the taxpayer held the asset.[15]

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[15] Even if a taxpayer's sole motivation for acquiring or manufacturing an asset is for the production of rental income, his gain on sale will be subjected to an ordinary tax if he thereafter enters into a new business and holds the assets for sale to customers in the ordinary course of that new business. Whether he is merely liquidating property held solely for the production of income or has entered into a new selling business depends mainly on the extent of his selling activities. See, *e.g.*, *American Can Co.* v. *Commissioner,* 317 F. 2d 604 (C.A. 2), certiorari denied, 375 U.S. 993; *Recordak Corp.* v. *United States,* 325 F. 2d 460 (Ct. Cl.); *Patterson* v. *Belcher,* 302 F. 2d 289, 297–298 (C.A. 5), certiorari denied, 371 U.S. 921. For example, if a large car rental agency acquires new cars solely because of the rental income they will produce, it is normally entitled to capital gain on their sale, but if the company opens a used car lot and sells the used rental automobiles at retail to the public, its gain or loss is taxed at ordinary income rates. See, *e.g.*, Rev. Rul. 54–229, 1954–1 Cum. Bull. 124; cf. *Greene-Haldeman* v. *Commission,* 282 F. 2d 884 (C.A. 9); *Harrah* v. *Commissioner,* 30 T.C. 1236, 1241.

II

THE LOWER COURTS CORRECTLY FOUND THAT ONE OF THE ESSENTIAL OR SUBSTANTIAL PURPOSES FOR HOLDING THE PROPERTY WAS FOR SALE TO CUSTOMERS IN THE ORDINARY COURSE OF BUSINESS

Whether a taxpayer's activities in a particular area are sufficiently substantial to constitute a trade or business is essentially a factual issue. The courts have enunciated a series of factors bearing on this question, including the number, continuity and frequency of the taxpayer's transactions, the amount of activity engaged in by the taxpayer or those acting under his instructions or in his behalf, and the extent or substantiality of the taxpayer's transactions. Once the trier of fact, using a correct legal standard, has found that the taxpayer was engaged in a trade or business and that the property in question was held for sale in the ordinary course of that trade or business, the appellate courts have generally reversed only if these findings were clearly erroneous.[16]

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[16] See, *e.g.*, *Ackerman* v. *United States*, 335 F. 2d 521 (C.A. 5); *Broughton* v. *Commissioner*, 333 F. 2d 492 (C.A. 6); *Stockton Harbor Industrial Co.* v. *Commissioner*, 216 F. 2d 638, 650, 655–656 (C.A. 9) certiorari denied, 349 U.S. 904; *Yara Engineering Corp.* v. *Commissioner*, 344 F. 2d 113 (C.A. 3); *Pennroad Corp.* v. *Commissioner*, 261 F. 2d 325, 330 (C.A. 3), certiorari denied *sub nom. Madison Fund, Inc.* v. *Commissioner*, 359 U.S. 958; *Coffey* v. *United States*, 333 F. 2d 945 (C.A. 10); *Mauldin* v. *Commissioner*, 195 F. 2d 714, 716–717 (C.A. 10); *Brady* v. *Commissioner*, 25 T.C. 682, 690; Mertens, *Law of Federal Income Taxation*, Vol. 3B, pp. 76–77; Note, "*Dealing*" *in Real Estate*, 2 Tax L. Rev. 111, 115–120 (1946); American Law Institute, *Definitional Problems in Capital Gains Taxation*, Discussion Draft, pp. 311–331 (Oct. 20, 1960).

The district court in the instant case necessarily reached two factual conclusions; first, that the joint venture was in the business of selling real estate, and, second, that one of the essential or substantial reasons for acquiring and holding[17] the property here in question was for sale to customers in the ordinary course of that business.[18] The court of appeals affirmed both of these essentially factual determinations and "in the absence of very exceptional showing of error" this Court will treat as "final" the "concurrent findings of the two courts below." *Comstock* v. *Group of Investors,* 335 U.S. 211, 214; see also, *e.g., Corn Products Co.* v. *Commissioner,* 350 U.S. 46, 51.[19] However, since petitioner spends a substantial portion of his brief attacking these factual findings we will demonstrate that they are, as the court of appeals noted, "amply support[ed]" by the record (R. 34).

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[17] Although the district court framed its finding in terms of the taxpayer's reasons for acquiring and holding the property, the statutory test is solely the purpose for which the property was "held." The motive for its acquisition is important only insofar as it sheds light upon the purpose of the holding. See *supra*, p. 22, n. 15.

[18] Because petitioner had the burden of proof, the district court phrased its ultimate finding in the negative, *i.e.*, that "Plaintiffs have failed to establish by a preponderance of the evidence that the subject real properties were not held by Plaza primarily for sale to customers in the ordinary course of trade or business" (R. 24; see also R. 16–17).

[19] The *Corn Products* case involved precisely the same type of question as is presented here. The Tax Court and court of appeals had both found that the taxpayer's corn futures transactions were "an integral part of its manufacturing business" and that its profits were not entitled to capital gain treatment despite the inapplicability of a statutory exception. In affirming, this Court refused to review that "essentially factual" finding and examined only the legal question.

The venturers, at least three of whom were engaged in the real estate business (see *supra*, pp. 3–4, 4–5 and *infra*, pp. 27–28), purchased the 45 acre tract here in question because it was located in a "fast-growing area" (R. 42, 114–115) and they were able to make "a good buy on the property as far as price [was] concerned" (R. 116). While they hoped to arrange financing that would enable them to build apartment buildings or other suitable structures on the property, they knew before acquisition that the mortgage market was "rough" and that there was a substantial chance that no construction would be undertaken (R. 83–84, 118, 116). In fact, they never had any intention of building on the property unless they could obtain financing on terms that would make it more profitable to retain the land rather than to sell it (R. 118, 100, 116). From the outset the venturers realized that the low price at which they had acquired the property gave them "a chance to make a very substantial profit on the sale or sales," either by subdividing or selling in bulk or some combination thereof (R. 100, 116). Within two months after the acquisition they subdivided 25 acres, installed streets and utilities, and began selling lots. Within 9 months after the original acquisition they had sold all 105 lots. The fact that some (if not all) of the venturers were regularly in contact with real estate buyers and developers in the regular course of their businesses combined with the location of the property in a rapidly growing area undoubtedly made it

unnecessary for them to advertise for buyers.[20] Even before the last of the 105 subdivision lots were sold, the venturers received "feelers" from brokers and others interested in purchasing the two frontage parcels (R. 114, 9, 23–24). The best offers—totalling more than $345,000—were made by George Ponty and the Hicks-Fenmore Development Co. After discussing whether to accept these offers or seek additional buyers, they decided that these were too good to reject (R. 101, 100, 118, 116).

Moreover, the venturers had already admitted that the joint venture was in the real estate business when it subdivided the 25 acre interior portion of the property here in question. They reported the gain from the sale of the resulting 105 lots as ordinary business income. This would have been proper only if the venture was engaged in the business of selling real estate and was holding the land for sale to customers in the ordinary course of its trade or business, the very question involved in the instant case.[21]

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[20] See, *e.g.*, *Brady* v. *Commissioner*, 25 T.C. 682, 690; *Pennroad Corp.* v. *Commissioner*, 261 F. 2d 325, 330 (C.A. 3), certiorari denied *sub nom. Madison Fund, Inc.* v. *Commissioner*, 359 U.S. 958; *Stockton Harbor Industrial Co.* v. *Commissioner*, 216 F. 2d 638, 655–656 (C.A. 9), certiorari denied, 349 U.S. 904; *Coffey* v. *United States*, 333 F. 2d 945 (C.A. 10); *Mauldin* v. *Commissioner*, 195 F. 2d 714, 717 (C.A. 10); American Law Institute, *Definitional Problems in Capital Gains Taxation*, Discussion Draft, pp. 318–327 (Oct. 20, 1960).

[21] It is irrelevant that the joint venturers removed the subdivided 25 acres from the original joint venture after the utilities had been installed and had a second joint venture make the sales of the 105 lots. Whether the joint venture is in business depends on the substance of the activities rather

Finally, the evidence shows that the three most active members of the joint venture were engaged in the real estate business.[22] Lesser Enterprises (in which petitioner was an active general partner and through which petitioner derived his share of the gains here in question) was engaged in the full time business of exploiting real estate in any fashion which

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than the formalities. A taxpayer or group of taxpayers cannot turn ordinary income into capital gain by formally dividing the ownership of his or their assets between two joint ventures. See, *e.g.*, *Broughton* v. *Commissioner*, 333 F. 2d 492, 495–496 (C.A. 6).

[22] If the joint venture which held the land was in the real estate business, all of the venturers' gains on the sales here in question would be taxable as ordinary income. 1954 Code § 702 (b). In making such a determination the fact that the active or managing venturers were engaged in very similar or even identical businesses would certainly be relevant. See, *e.g.*, *Broughton* v. *Commissioner*, 333 F. 2d 492, 495–496 (C.A. 6); *Ackerman* v. *United States*, 335 F. 2d 521 (C.A. 5); *Margolis* v. *Commissioner*, 337 F. 2d 1001, 1005–1007 (C.A. 9), rehearing denied, 339 F. 2d 537 (C.A. 9); *Rossiter* v. *United States*, 60–1 U.S.T.C. para. 9170 (N.D. Ill., Dec. 11, 1959); *Schultz* v. *Commissioner*, 44 B.T.A. 146, appeal dismissed, 123 F. 2d 1020 (C.A. 9); *Goodman* v. *Commissioner*, 40 B.T.A. 22. Cf. Treas. Reg. § 1.1375–1(d). However, even if under this test the joint venture had not been in the real estate business, Lesser Enterprises' (and thus petitioner's) share of the gain would nevertheless have been taxable as ordinary income. A taxpayer who is engaged full time in the real estate business cannot transform his profits into capital gain by actively engaging in business through a number of joint ventures. In such a case a taxpayer's real estate activities will be viewed as a unit and his share of the gains taxed accordingly. Cf. 1954 Code § 751(d)(2)(D) (certainly if—as this Code section requires—a partner's gain on the sale of his partnership interest will be taxed as ordinary income to the extent that it is attributable to assets held by the partnership that would be inventory in his hands, the same must be true if the assets were sold directly by the partnership); Treas. Reg. § 1.1375–1(d); 1954 Code § 341(e)(5).

proved to be most profitable at the moment. Shortly after the sale here in question Lesser Enterprises had approximately $1,200,000 invested in land, joint ventures and partnerships, and had in one year realized gains of approximately $645,000 in connection with real estate transactions.[23] Lesser Enterprises and petitioner were involved in the development of apartment buildings, homes, an office building, and shopping centers; they had also sold a substantial amount of land, both by subdividing and, where more profitable, in larger tracts. In the five years since Lesser Enterprises had been organized it had participated in at least five bulk sales of land for more than $950,000. The other two active venturers, Hicks and Fenmore, were also actively engaged in the real estate business (see *supra*, pp. 4–5).[24]

Based on this evidence the district court correctly concluded that petitioner had failed to sustain his

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[23] The breakdown is as follows:

Net profit on sales of land	$230,000
Net profit from partnerships and ventures in real estate	275,000
Net profit from real estate commissions (gross fees $171,000, less $31,000 expenses)	140,000
Total	645,000

See *supra*, pp. 3–4; Ex. A (unprinted).

[24] In this respect the situation is far different from that considered in Rev. Rul. 57–565, 1957–2 Cum. Bull. 546, where a taxpayer not otherwise in the real estate business was not regarded as holding a large piece of land for sale to customers merely because he had subdivided a part of the tract. The instant case is far closer to that discussed in Rev. Rul. 62–141, 1962–2 Cum. Bull. 182, and *Goldsmith* v. *Commissioner*, 143 F. 2d 466, 467 (C.A. 2) (opinion of Judge L. Hand), certiorari denied, 323 U.S. 774.

burden of proving that the property was not held for sale to customers in the ordinary course of business. Petitioner cannot escape the district court's findings by arguing that the joint venture's business must be narrowly viewed, *i.e.*, that the business included only sales of residential real estate. To fragment the venture's activities and label only some a business and the rest as outside the scope of the business would permit easy evasion of Congress' intent that all profits from normal business transactions be taxed as ordinary income.

Petitioner apparently contends, however, that even if one of the essential or substantial reasons for holding the property was for sale in the ordinary course of business, nevertheless, the sale to Hicks-Fenmore Development Co. was in essence a sale by three of the joint venturers to the other two joint venturers and thus was not a sale to customers in the ordinary course of business. There are at least two answers to this argument. First, petitioner and the other venturers sold the property to Hicks-Fenmore Development Co. only because it made a better offer than the other available buyers; in this sense Hicks-Fenmore Development Co. was no different than any other customer. See, *e.g.*, *Patterson* v. *Belcher*, 302 F. 2d 289, 290–294 (C.A. 5), certiorari denied, 371 U.S. 921 (holding that sales to a related corporation can constitute sales to customers in the ordinary course of business). The courts have long held that anyone engaged in the business of selling property sells it to customers whenever he finds someone who

will purchase it. In one frequently cited case the Board of Tax Appeals held that:

> Where, as here, one is regularly engaged in the business of buying and selling real estate, as was petitioner, any person who can be found to buy such property is a customer, as that term is ordinarily understood, and where such property is held for sale under such circumstances it must be deemed to be held for sale to customers within the meaning of the statute. [*Black v. Commissioner,* 45 B.T.A. 204, 210.]

As Judge Learned Hand stated the same principle, those "whose custom the taxpayer seeks * * * are his 'customers.'" *Goldsmith* v. *Commissioner,* 143 F. 2d 466, 468 (C.A. 2), certiorari denied, 323 U.S. 774. See also *Gamble* v. *Commission,* decided October 27, 1955 (P-H Memo T.C., para. 55,289, affirmed, 242 F. 2d 586 (C.A. 5) ("one engaged in the continuous purchase and sale of property, as this petitioner was, has dealings with a 'customer' whenever he sells."); *Pennroad Corp.* v. *Commissioner,* 261 F. 2d 325, 330 (C.A. 3), certiorari denied *sub nom. Madison Fund, Inc.* v. *Commissioner,* 359 U.S. 958; *Stockton Harbor Industrial Co.* v. *Commissioner,* 216 F. 2d 638 (C.A. 9), certiorari denied, 349 U.S. 904. Cf. *Watson* v. *Commissioner,* 345 U.S. 544.[25]

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[25] As pointed out *supra*, p. 14, fn. 10, the words "to customers" and "ordinary" were added to the statutory language in 1934 in order to prevent people who were actively trading in the stock market from contending that their activities were sufficient to constitute a trade or business and thus permitting them to deduct stock market loses suffered during the depression as ordinary rather than capital losses. Since stock market speculators sell a fungible item to buyers they never see,

Second, even if the transaction with Hicks-Fenmore Development Co. were not a sale to a customer in the ordinary sense, petitioner's gain would nevertheless be taxable as ordinary income. Section 1221(1) does not refer to the manner in which the property was sold, but to the purpose for which it was held. As this Court has recognized, if a taxpayer sells his entire business, he must report the gain on property held for sale to customers as ordinary income although it was sold in bulk rather than in the normal course of business. *Watson* v. *Commissioner*, 345 U.S. 544. See also *Williams* v. *McGowan*, 152 F. 2d 570 (C.A. 2); *Monaghan* v. *Commissioner*, 40 T.C. 680; Rev. Rul. 55–79, 1955–1 Cum. Bull. 370.[26]

Congress believed that requiring a sale to be not merely "in the course of business" but also "to customers" would exclude them. While the original purpose of the 1934 amendment was "to prevent tax avoidance" by "a stock speculator trading on his own account," S. Rep. No. 558, 73d Cong., 2d Sess., p. 12 (1939–1 Cum. Bull. (Part 2) at 595); H. Conf. Rep. No. 1385, 73d Cong., 2d Sess., p. 22 (Amendment No. 66) (1939–1 Cum. Bull. (Part 2) at 632), the amendment created a permanent exception to the general rule that if a taxpayer's activities are sufficient to constitute a business his normal gains will be taxed as ordinary income. (Thus today even an active securities trader is entitled to capital gain treatment.) Therefore, in the context of a taxpayer actively engaged in the real estate business, the words "to customers" add little to the statutory requirement that the sales be in the ordinary course of his business. *Kemon* v. *Commissioner*, 16 T.C. 1026, 1032; Mertens, *Law of Federal Income Taxation*, Vol. 3B, p. 79–80; Note, "*Dealing*" *in Real Estate*, 2 Tax L. Rev., 111, 114–115 (1946); American Law Institute, *Definitional Problems in Capital Gains Taxation*, Discussion Draft, pp. 330–331 (Oct. 20, 1960).

[26] Finally, petitioner contends that the sale to Hicks-Fen-

In summary, Congress intended "to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time." *Commissioner* v. *Gillette Motor Co.,* 364 U.S. at 134; see H. Rep. No. 350, 67th Cong., 1st Sess., pp. 10–11 (1939–1 Cum. Bull. (Part 2) at 176); S. Rep. No. 275, 67th Cong., 1st Sess., pp. 12–13 (1939–1 Cum. Bull (Part 2) at 189–190). Petitioner's gains here in question are, on the other hand, typical profits generated by active participation in a business enterprise. Within 9 months after acquiring the land, the venturers (at least three of whom were actively engaged in the real estate business) installed roads and utilities, and sold 105 residential lots and two 10 acre parcels. The joint venture's conceded business activities in subdividing the 25 acres undoubtedly played a substantial part in causing the adjoining 20 acres here in question to rise so rapidly in value during the less than nine months the joint venture held it (R. 112, 114–115). Profits made in such a manner are the antithesis of passive, long term accretions in value and fall squarely in the category of "profits * * * arising from the everyday operation of a business" which Congress intended to tax "as ordinary income * * * rather than capital gain." *Corn Products Co.* v. *Commissioner,* 350 U.S. at 52.

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more Development Co. was really like a sale of his (*i.e.*, Lesser Enterprises') interest in the joint venture. Pet. Br. p. 10. Even if this were so, his gain on the sale would clearly be ordinary income if the property here in question had been held for sale to customers. 1954 Code § 751.

CONCLUSION

The judgment below is correct and should be affirmed.

Respectfully submitted.

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